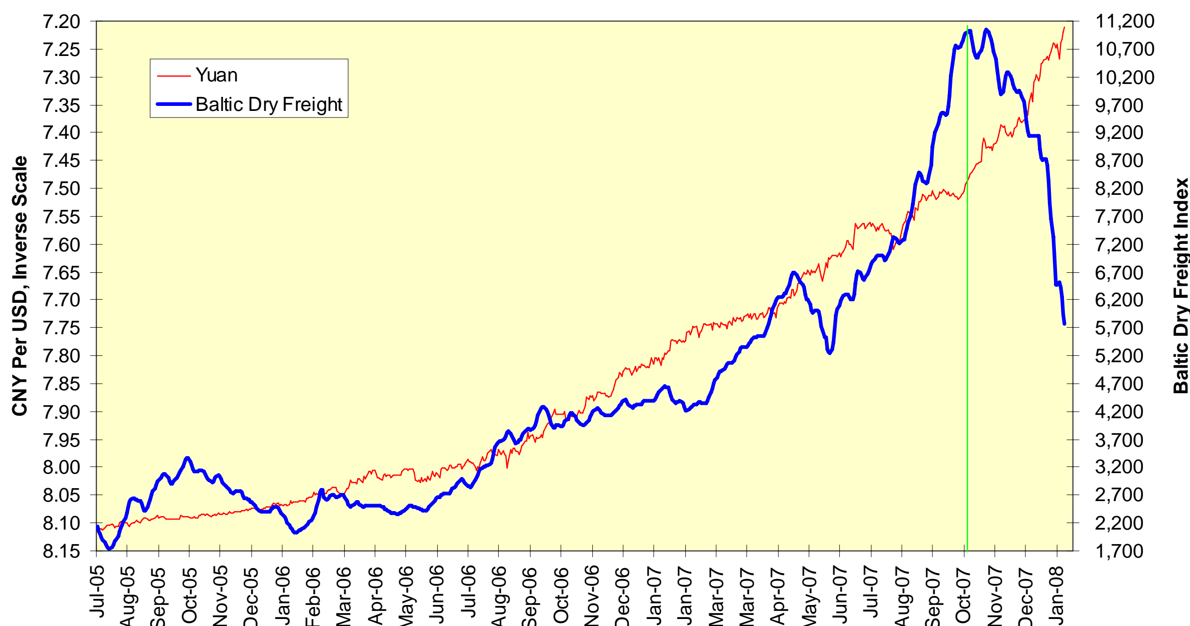
A-Freight Of The Yuan

All traders have felt the sting of an adverse move in the market and wondered, "How did they know? How did the market know I was hung out to dry on [fill-in-the-blank]?" On one level this question is nonsense; after all, prices only can rise or fall, and the fact you had a position affected thereby is incidental in the grand scheme of things.

On another level, markets tend to gravitate toward the pole of the greatest collective anxiety. As traders, both those who work for certain French banks and those who do not, tend to resist taking small losses early on bad positions they wind up taking large losses at a later date. If we throw options and other forms of insurance into the mix – insurance changes behavior – we can get a toxic stew.

Finally, if we add shortsighted official policies into the equation, we can get a real disaster. Such has been the case with the incessant protectionist carping about the Chinese yuan. I warned last April how a stronger yuan would act both as a tax on the American consumer and the Chinese producer at a time when the global economy was facing rising long-term interest rates.

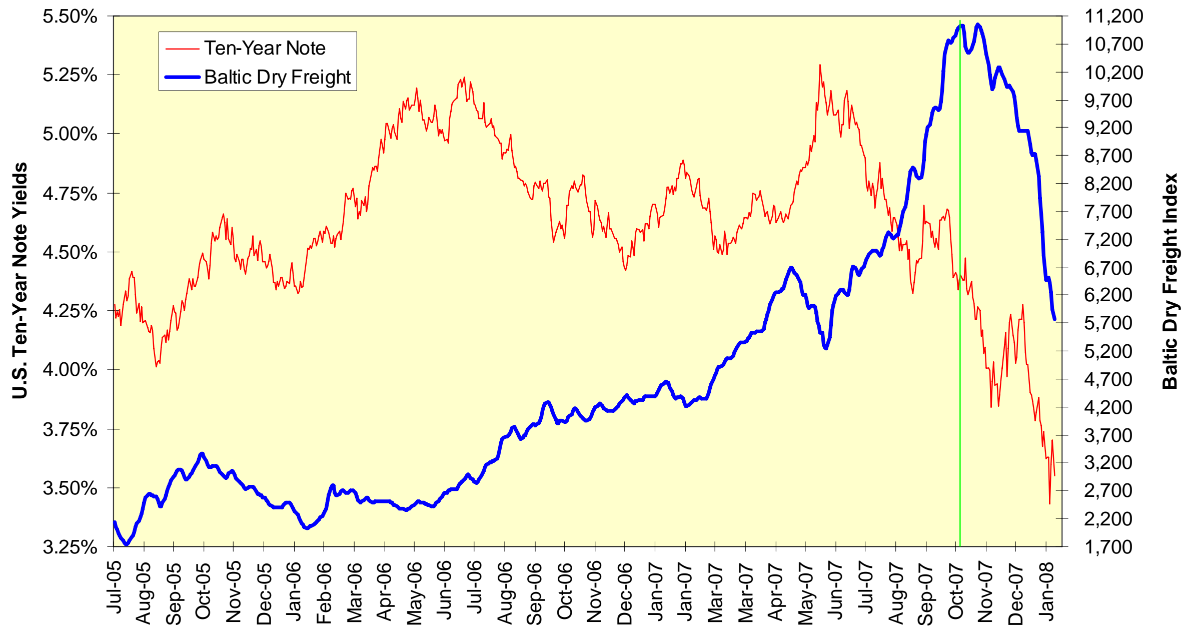
Consequences Of The Stronger Yuan
China acceded to a faster revaluation in the yuan last October. The Baltic Dry Freight index, which I first addressed in the context of trans-Pacific trade and U.S. bond yields in April 2004, hit its first peak on October 29, 2007, marked with a green line. It has plummeted 47.6% in just three months. This suggests some serious declines in demand for ocean shipping and, of course, global economic weakness.



Last April's warning about the yuan came well before this macroeconomic weakness and after the first subprime-related financial crisis of 2007, the one at the end of February. It also came well before the Federal Reserve adopted its recent policy of cutting interest rates in a panic each time the stock market swooned.

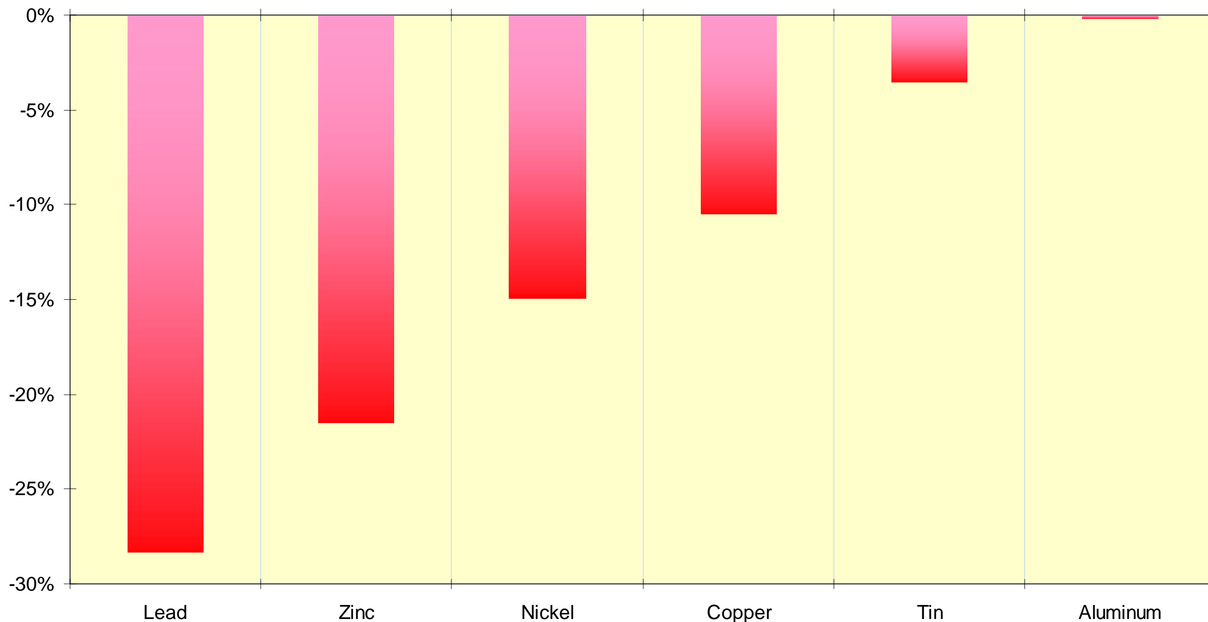
The relationship between freight rates and long-term interest rates had been negative between 2002 and 2004. This was explicable by China and other Asian exporters recycling their export earnings into U.S. financial assets and exerting downward pressure on interest rates; Alan Greenspan referred to these low long-term rates as a "conundrum."

The relationship between freight rates and long-term interest rates shifted to a strongly positive one after October 2007. The confluence indicates a slowdown in growth coupled with a flight from risky assets.



No Petals For Metals

I wrote last November how the prices for base metals likely were topping. As these metals are excellent coincident indicators of macroeconomic activity, let's take a look at how various three-month forwards traded on the London Metals Exchange have behaved since the Baltic Dry Freight index hit its first peak.

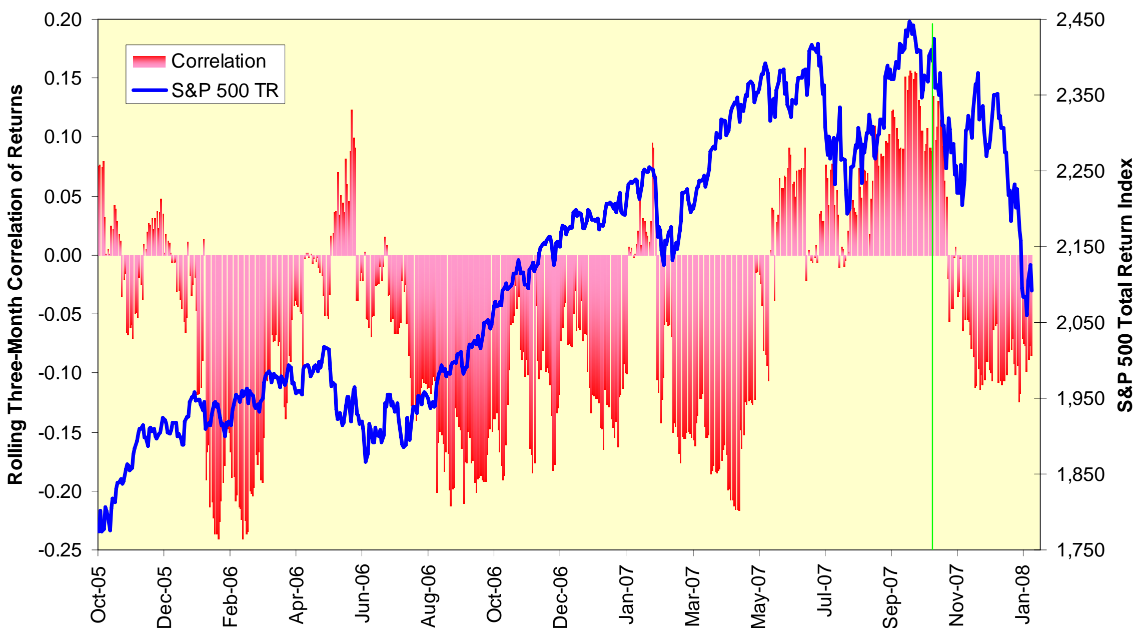


The prices for aluminum and tin have held up reasonably well, but those for copper, nickel and especially lead and zinc have cratered. This presents an interesting dilemma for those who claim commodity prices simply are a reflection of the dollar. The yuan has appreciated 3.52% against the dollar during this period, and the broad dollar index has fallen a mere 1.12%. Unless there are some perfectly bizarre elasticities involved, neither move can account for the ongoing destruction of base metals prices.

If the global economy slows further and the Federal Reserve persists in its rate-cutting campaign, we should expect to see base metals prices decline even if the dollar weakens further.

The Stock Market Effect
Now let's ask whether U.S. stocks have been affected adversely by the rising yuan. The total return on the S&P 500 since October 29, 2007 has been -13.2%. As the returns on U.S. stocks are affected by hundreds of variables, it would be foolish to ascribe causality to the single variable of the rising yuan.

However, if we plot the rolling three-month correlation of returns for the yuan against those for the S&P 500 total return index since China began allowing the yuan to appreciate in July 2005, an interesting relationship emerges. The only period of sustained positive correlation of returns occurred between June and October 2007. Other than that period, which included both the July-August selloff and the September-October rally, the correlation of returns between stocks and the yuan has been negative. Moreover, once the accelerated appreciation of the yuan began in October, the correlation has been negative.



It is quite difficult to look at the chart above as a holder of U.S. equities and wonder why a stronger yuan is such a great idea.

China has been trying to rein in its rampant growth to curb domestic inflation. They see, as did Japan in the late 1980s, a stronger currency as one way of achieving this goal. As I noted last week in the context of the long-term analog between the U.S. and Japan, the bursting of long-running investment bubbles and their concomitant macroeconomic imbalances can produce economic stagnation lasting for decades.

If China continues to use a rising yuan as a policy tool while the rest of the world is slowing down, with the various effects noted above as evidence, the results are going to remain ugly. Our focus as investors really has to remain, "how should I protect my capital" far more than "what should I buy?"